

**THE EUROPEAN UNION'S RESPONSE TO THE GLOBAL FINANCIAL
CRISIS – CAN MEMBER NATIONS AVOID A MOVE TO
PROTECTIONISM?**

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The economic integration of a 27 countries into the European Union (EU) has embraced both rich and not so rich countries with the mandate of working together with the single aim of a free market economy focused on strong economic growth. After an extended period of such growth, the EU finds itself in the midst of the global financial crisis. This article looks at the effect of the global financial crisis on the European Union, the responses formulated by the European Commission as well as responses by individual Member States. The article also comments on certain Member States that are adopting protectionist strategies in order to survive the current economic downturn.

The global financial crisis has seen stock markets round the world plummet, a sharp decrease in the supply of inter-bank credit and financial markets become disarrayed. The effects of the crisis on well developed economies have been twofold. Firstly unemployment has risen and continues to rise as firms tighten belts or at worst become insolvent. The Gross Domestic Product (GDP) of both developed and developing nations has dropped due to the severe downturn in global trading.

Unlike economic downturns of the past, national approaches to the current crisis cannot solve the problem. Rather a global approach is vital. The G20 summit in April 2009 promulgated stimulus packages and concluded that the regulation of global financial markets is essential in order to avoid a repeat of what is essentially an economic catastrophe.

On 15 September 2008, the alarm bells rang signaling that all was not well in the United States (US) economy when Lehman Brothers declared bankruptcy with USD639 billion in outstanding debts. It was the largest bankruptcy event in the history of the US and sent shockwaves through a market that had just witnessed the nationalization of US financial giants Fannie Mae and Freddie Mac. On 16th

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September 2008 the Federal Reserve bailed out another American giant, AIG, providing USD85 billion to cover their exposure to toxic securitized loans and credit default swaps. Two days later, the US Government announced a USD750 billion program to buy toxic assets from banks and announced bank deposit guarantees for all banks¹. The impact of these events resulted in a decline in consumer confidence and liquidity since termed the Global Financial Crisis because its effects have been felt all over the world.

At first Nation States in the EU viewed the financial crisis as a purely 'American' problem. However this view changed as economic activity in Europe declined rapidly over a short period of time, witnessed by a sharp decline in global trade resulting in the erosion of the market for European exports, which have typically provided a safety valve for domestic industries cutting output².

According to Dick Nanto, the global financial crisis seems to be affecting the global economy on two fronts³. The first is among the more developed global economies where subprime mortgage losses were much higher and there was excessive leveraging of investments, resulting in some investments with negative equity. This has been compounded by a lack of credit default swaps; a financial instrument used as a form of insurance policy against securitized mortgage defaults.

In particular Great Britain has suffered more than other EU countries as it was vulnerable to the global financial crisis on three fronts. Firstly, the British economy was exposed directly to the credit crisis through the activities of its own large banks and by London's position as an international finance centre. As confidence in the banking and financial sectors failed, large losses were crystallized. This affected Great Britain in much the same way as the United States as the services and financial industry makes up a large part of the British economy. Secondly, British households had run up the biggest debt relative to disposable income of all the G7 nations attributable to the easy availability of consumer credit loans. The effect of this over extension has been evidenced by bankruptcy rates, which have tripled since the equivalent period in 2004⁴. Finally, British house prices had risen extremely quickly in an overheated market during the preceding years⁵. An abundance of zero and negative equity loans have multiplied the effects of falling property prices.

¹ Nanto, D. K. (2009, April 3). *The Global Financial Crisis: Analysis and Policy Implications*. Federation of American Scientists:
<<http://www.fas.org/sgp/crs/misc/RL34742.pdf>> accessed 20 April 2009

² Ibid.

³ Ibid.

⁴ Hickman, M. (2008, January 2). *Broke Britain: millions face struggle to stay afloat as financial crisis hits home*. The Independent:
<<http://www.independent.co.uk/news/uk/home-news/broke-britain-millions-face-struggle-to-stay-afloat-as-financial-crisis-hits-home-767584.html>> accessed 27 April 2009

⁵ *Not so great Britain*. (2009, April 24). The Financial Express:
<<http://www.financialexpress.com/news/not-so-great-britain/450469/2>> accessed 27 April 2009

I EUROPE'S RESPONSE

Unveiled by President Jose Manuel Durao Barroso in November 2008, the European Commission's coordinated response to the global financial crisis has, in its own words, two key pillars: -

- “A major injection of purchasing power into the economy to boost demand and stimulate confidence”, the substance of which was an immediate injection of €200 billion (or 1.5% of GDP); and
- “The need to direct short-term action to reinforce Europe's competitiveness in the long term”. This is made up of “smart investment” and other terms amounting to protectionism in the European single market in the form of localized stimulus packages.⁶

At the G20 summit in April 2009 the EU contributed €75 billion – 100 billion to reinforce the mandate of the International Monetary Fund's resources.⁷

Following that meeting, the EU put €300 billion worth of recapitalizations and €2.5 trillion worth of guarantees into the financial system.⁸ €400 billion has been put into initiatives to help industry and businesses and support public investment projects and assist household purchasing power.⁹ However the European Commissioner Joaquin Almunia acknowledges that financial assistance alone is not enough but requires reforms in the area of regulation and supervision of the financial markets. On 29 April 2009 the European Commission proposed a Directive on Alternative Investment Fund Managers to create a comprehensive regulatory and supervisory framework at the European Level. The proposed Directive is designed to enable Member States to improve ‘the macro-prudential oversight of the sector and to take coordinated actions as necessary to ensure the proper functioning of financial markets.’ This, it is envisaged, will tighten up existing regulatory frameworks at national levels.¹⁰

These responses to the crisis and the fiscal packages that have followed have drawn much criticism particularly of inactivity and of a lack of coordination between Member States. Is this criticism valid? It is important to note that the European

⁶ Commission of the European Communities. (2008, November 26). *Communication from the Commission to the European Council - A European Economic Recovery Plan*. from Europa.eu: <http://ec.europa.eu/commission_barroso/president/pdf/Comm_20081126.pdf> accessed 22 April 2009

⁷ Joaquin Almunia European Commissioner for Economic and Monetary Policy ‘Confronting the global Financial Crisis: The European Response John Hopkins School of Advanced International Studies Washington 24 April 2009 Speech 09/195 <europa.eu/rapid/pressReleasesAction.do?reference=SPEECH/09/195&format=...> accessed 9 May 2009

⁸ ibid

⁹ ibid

¹⁰ Proposal for a Directive on Alternative Investment Fund Managers. <Ec.europa.eu/internal_market/investment/alternative_investments_en.htm> accessed 11 May 2009

single market was based on the notion of free trade, which is inherently anti-regulation. Also, as has been discussed, many European banks did not have the exposure to the subprime mortgage crisis as did their counterparts in the United States and, subsequently, are not in such dire straits. The EU Commission perceives the main problem in the Community as a lack of confidence in the banking sector, resulting in investors withdrawing liquidity from the market. In a press conference in Brussels in October 2008, Mr. Barossa reiterated that the challenge was to “inject credibility”¹¹ into financial markets as well as providing additional liquidity. The use of two “pillars” in the economic recovery plan serves to show the two fronts on which the Commission wishes to address the current crisis. These fronts are discussed below.

II MONETARY POLICY

The Commission’s Economic Recovery Plan sets out the guidelines for the role of the European Central Bank (ECB). Its main role is to maintain stability and confidence in the banking system and to encourage banks to resume normal lending practices and ensure central bank interest rate cuts are passed on to customers. The ECB aims to achieve this by guaranteeing supply of credit at the set rate. This represents a departure from convention as usually the ECB will provide a set amount of cash to the market at allow market forces to determine the interest rate for access to funds¹². With a guaranteed supply of cash, banks will be encouraged to seek credit and to resume normal lending activities. The intended effect will be that confidence is restored to the market, allowing the financial system to continue its recovery.

Some commentators view this role as very limited, especially in comparison to the role taken on by the United States Federal Reserve in buying up toxic assets and government bonds¹³. It is arguable, however, that by engaging in the purchase of such toxic assets, the central bank is acting outside its prescribed monetary policy guidelines. Furthermore, such transactions within the marketplace can be easily interpreted as participating in fiscal policy, which blurs the line between government and the supposedly independent central bank. ECB Chief Jean-Claude Trichet defended the Bank’s position in a speech in Tokyo in April 2009. In his address, Mr. Trichet made the point that “as compared to the United States, which has primarily a market-based financial system, the euro area is very largely bank-centred”¹⁴. This implies that by purchasing capital market financial instruments

¹¹ Barroso, J. M. (2008, October 1). Remarks of President Barroso on financial crisis. Brussels.

¹² Trichet, J.-C. (2009, April 17). *Restoring confidence in the global financial system*. from European Central Bank: <<http://www.ecb.int/press/key/date/2009/html/sp090417.en.html>> accessed 26 April 2009

¹³ Liquidity Carrier. (2009, April 3). *The Economist*, 390 (8624), p. 73.

¹⁴ Trichet, J.-C. (2009, April 17). *Restoring confidence in the global financial system*. from European Central Bank: <<http://www.ecb.int/press/key/date/2009/html/sp090417.en.html>> accessed 26 April 2009

such as government bonds, the ECB would not be engaging in monetary policy suitable to the financial system of the European Union.

III FISCAL POLICY

The implementation of fiscal policy has arguably been the most contentious issue with regard to Europe's response to the global financial crisis. Although the Commission has set general guidelines as to how much member states should allocate to fiscal stimulus and where it should be directed¹⁵, the issue of exactly how the stimulus packages should be implemented remains to be resolved. Additionally, the allocation of responsibility for allocating stimulus funds to member states has resulted in a return to protectionism, with voters asserting that taxpayer funds should be used to benefit only those within the country. Examples of incidents of protectionism by various countries are outlined below.

This political pressure was evident in French president Nicolas Sarkozy's treatment of the Peugeot group. In February 2009, the French government approved a loan of USD3.9 billion to save Peugeot Citroen on the proviso that the factory closures to not occur in France. Mr. Sarkozy was quoted as saying that money was not to be given to the auto industry "so we can hear about a new plant moving to the Czech Republic or wherever"¹⁶. Such blatant protectionism is not surprising given its history for socialism and political activism. French politicians have urged the president to protect more French jobs, keep factories open and curb bosses' pay¹⁷.

More of a surprise, however, is the action taken by German government who, historically, has prided itself on balanced budgets and isolating itself from corporate matters in its social market economy¹⁸. However in light of the current financial crisis – and, again, its effect on the auto industry – the German government has introduced a buy-back scheme for old cars to encourage consumption¹⁹ and is currently mulling a bail-out of GM subsidiary, Opel²⁰. It should come as no

¹⁵ Commission of the European Communities. (2008, November 26). *Communication from the Commission to the European Council - A European Economic Recovery Plan*. (pp7-16) from Europa.eu:

<http://ec.europa.eu/commission_barroso/president/pdf/Comm_20081126.pdf> accessed 22 April 2009

¹⁶ BBC News. (2009, February 11). *Peugeot Citroen cuts 11,000 jobs*. from BBC News: <<http://news.bbc.co.uk/2/hi/business/7882913.stm>> accessed 27 April 2009

¹⁷ The Economist. (2009, March 12). *Back in the driving seat*. <http://www.economist.com/displayStory.cfm?story_id=13279527> accessed 25 April 2009

¹⁸ Witt, U. (2002). Germany's "Social Market Economy". *The Independent Review*, VI (3).

¹⁹ Reuters. (2009, January 26). *Government incentives brighten German car outlook*. from Automotive News <Europe: <http://www.autonews.com/article/20090126/ANE02/901260272/1033>> accessed 26 April 2009

²⁰ The Economist. (2009, March 12). *How to restart the engine?* from The Economist: <http://www.economist.com/world/europe/displaystory.cfm?story_id=13279511> Accessed 20 April 2009

surprise that the auto industry is receiving a helping hand. Firstly the ability to build a car has always been a matter of national pride. This is especially true of the Germans, who are well aware that their cars are considered by many to be the best in the world. As such, any effort to prop up the ailing industry is also a good political move²¹.

Politicians in the Netherlands have voiced similar concerns about the flow of capital outside national borders. Prime Minister Jan Peter Balkenende recently conceded that Member States were under “intense pressure to use scarce tax revenues mainly for our own countries”. The concern is based around the fact that although the economic and social pains being faced by governments such as rising unemployment and social welfare bills and decreasing tax revenue are felt at the national level, the gains that will result from any stimulus activity will inevitably leak across national borders due to the single market²².

The Commission’s support of protectionism is surprising. Article 14 of the Treaty provided for ‘an area without internal frontiers in which the free movement of goods, persons, services and capital is assured’. Restricting the flow of funds to within national boundaries creates artificial barriers to the free movement of capital and threatens the legitimacy of the single market. In addition, it promotes potentially inefficient industry. The same argument has been used in the United States regarding General Motors (of which Opel is a subsidiary). A CNN opinion poll has shown that 76 per cent of respondents would rather American automakers face bankruptcy than receive more government funds²³. By injecting scarce stimulus funds into inefficient businesses member states risk missing the mark with their stimulus packages and prolonging the economic pain.

Despite its perceived vulnerabilities and a forecasted 4.1 per cent drop in GDP²⁴, Great Britain’s economy has fared better than first expected. With limited dependence on the manufacturing sector (only 13 per cent of GDP), the decline in consumption of expensive items such as cars have affected Germany and Japan more than Great Britain. In addition its larger manufacturing industries, pharmaceuticals and aerospace, are more recession proof than mainstream consumer products. This has also helped to shield Great Britain from the crisis in a small way. Interestingly, a 27 per cent slide in the value of the sterling²⁵ has also been beneficial to the British economy. British exporters have gained a slight edge, propping up a manufacturing industry suffering reduced demand at home. A

²¹ Ibid.

²² The Economist. (2009, March 19). *Dutch and the fiscal stimulus - Fingers in the dyke*. <http://www.economist.com/research/articlesBySubject/displaystory.cfm?subjectid=3856661&story_id=13325391> accessed 27 April 2009

²³ Clifford, C. (2009, April 9). *Let GM and Chrysler go bankrupt - CNN Poll*. <http://money.cnn.com/2009/04/09/autos/opinion_poll/index.htm?section=money_topstories> accessed 27 April 2009

²⁴ *United Kingdom and the IMF*. (n.d.). International Monetary Fund: <<http://www.imf.org/external/country/GBR/index.htm>> accessed 27 April 2009

²⁵ *Not so great Britain*. accessed 27 April 2009

slightly weaker sterling also helps combat deflation, which would otherwise increase the real cost of debt²⁶. This is especially important considering the high amount of leverage of both the average household and the government²⁷.

The second front on which the crisis is being played out on is that of the emerging markets. Many of these markets have been growing at an alarming rate due to an influx of foreign investment, proactive government policy and a renewed appetite for leverage. In the wake of the global financial crisis, however, many investors have pulled out of these markets in an effort to preserve capital. This is not reflective of the underlying strength of the emerging economies but has wreaked havoc with local currencies and capital reserves. Many of these countries have been forced to accept IMF funding due to the sudden withdrawal of capital. This is especially evident in Europe, with the economies of Ireland and the Eastern Europe, making full use of the availability of credit to finance their own bull markets.

Known as the Celtic Tiger, Ireland was a success story for the new economy. The combination of a low corporate tax rate (10-12.5 per cent), government and EU subsidies, relatively low wages and access to European markets encouraged many multinationals such as Microsoft and Dell to set up regional bases in Ireland²⁸. A low capital gains tax rate (20 per cent) and government programs²⁹ helped fuel the construction boom that employed thousands and made developers such as Sean Dunne instant celebrities with their excesses³⁰. Unlike their counterparts in the more developed financial world, Irish banks did not engage in as many subprime or securitized loans. Instead, these banks drastically increased their loans to developers³¹ and encouraged consumer debt.

Eastern Europe has been through a similar process. Fueled by relatively low wages and government reforms, the economies of Lithuania, Latvia and Estonia have grown at an average rate of 7 per cent per annum since 2000³² and has earned the

²⁶ Ibid.

²⁷ The current level of public debt is estimated at 59% of GDP, increasing to 79% by 2014.

²⁸ The Independent. (2004, October 24). *Low-tax policies created the Tiger - Editorial*. Retrieved April 2009, 24 from Independent.ie: <http://www.independent.ie/opinion/editorial/lowtax-policies-created-the-tiger-485406.html>

²⁹ Dorgan, S. (2006, June 23). *How Ireland became the Celtic Tiger*. The Heritage Foundation: <<http://www.heritage.org/Research/WorldwideFreedom/bg1945.cfm>> accessed 24 April 2009

³⁰ Thomas Jr, L. (2009, January 3). *The Irish Economy's Rise Was Steep, and the Fall Was Fast*. Retrieved New York Times: <http://www.nytimes.com/2009/01/04/business/worldbusiness/04ireland.html?_r=2&ref=europa> accessed 24 April 2009

³¹ Thomas Jr, L. (2009, January 3). *The Irish Economy's Rise Was Steep, and the Fall Was Fast*. The New York Times <http://www.nytimes.com/2009/01/04/business/worldbusiness/04ireland.html?_r=2&ref=europa> accessed 24 April 2009

³² International Monetary Fund. (n.d.). from April 2009 World Economic Outlook: <<http://www.imf.org/external/pubs/ft/weo/2009/01/weodata/weorept.aspx?sy=2000&ey=2009&ssm=1&scsm=1&ssd=1&sort=subject&ds=.&br=1&pr1.x=75&pr1.y=15&c=946%2>>

region the nickname the Baltic Tiger (similar to the Celtic and Asian Tigers before them). Soaring economic growth and current account deficits (up to 20 per cent of GDP in the case of Latvia) has been attributed to “reckless bank lending, particularly in construction and consumer loans”³³.

For both regions, the fallout from the economic crisis has been similar. In 2008, Ireland’s gross domestic product (GDP) fell 2.3 per cent - the largest annual decline since statistics were first compiled and the government predicts Ireland’s economy to shrink by a further 7 per cent in 2009. Unemployment has risen to 11 per cent and Ireland’s tax revenue has decreased by 23 per cent in the first quarter of 2009 accordingly. Public sentiment has soured, with the streets of Limerick – a town shaken by the loss of 2,000 jobs at Dell – adorned with posters that read “Rich get pay-offs. We get layoffs”³⁴.

Political unrest is also growing in Eastern Europe. T-shirts with slogans such as “Nasing spesal” – a play on the Latvian finance minister’s heavily accented assertion that his country’s economic problems were caused by “nothing special” – are selling fast, somewhat ironic considering Latvia’s retail sector as declined 17 per cent year on year. The economies of Eastern Europe are expected to decline by 3 per cent as a whole in 2009³⁵. More serious, however is the increase in political activism, with violent protests in Latvia, Lithuania, Bulgaria, the Czech Republic and Hungary following weeks of violence in Greece³⁶. Protests over government responses the financial crisis has seen the collapse of the government in both Iceland and Latvia³⁷.

Other countries in the region have not fared quite so badly. Despite a 30 per cent slide in its national currency (one of the few un-pegged Balkan currencies), Poland has fared surprisingly well. It is one of the few countries to be in a position to accept a €20.5 billion line of credit (to be distinguished from a bailout) from the

[C939%2C941&s=NGDP_RPCH%2CNGDPDPC%2CPCPIPCH%2CBCA_NGDPD&grp=0&a=>](#) accessed 26 April 2009

³³ The Economist. (2009, February 26). *Can eastern Europe avoid meltdown?* <http://www.economist.com/displayStory.cfm?story_id=13184594> accessed 26 April 2009

³⁴ Vennin, L. (2009, April 5). *Ireland's Celtic Tiger economy reduced to a purr* (AFP). Retrieved April 24, 2009 from Yahoo! News: http://news.yahoo.com/s/afp/20090406/bs_afp/financeeconomyireland_20090406034947

³⁵ The Economist. (2009, February 26). *Can eastern Europe avoid meltdown?* <http://www.economist.com/displayStory.cfm?story_id=13184594> accessed 26 April 2009

³⁶ Pan, P. P. (2009, January 26). *Economic Crisis Fuels Unrest in E. Europe*. The Washington Post: <http://www.washingtonpost.com/wp-dyn/content/article/2009/01/25/AR2009012502516_pf.html> accessed 24 April 2009

³⁷ Nanto, D. K. (2009, April 3). *The Global Financial Crisis: Analysis and Policy Implications*. from Federation of American Scientists: <<http://www.fas.org/sgp/crs/misc/RL34742.pdf>> accessed April 20, 2009

International Monetary Fund and is seen as more resilient due to government regulation and bureaucracies in place since the start of their economic boom³⁸.

IV CONCLUSION

It is generally accepted that to repair the inherent problems in the global economy, a period of pain must be endured in the present to secure the future. Looking forward, Europe's greatest challenge lies in the actual preservation of the common market. The first problems to be addressed are the temptation to ramp up protectionism for the sake of a political agenda. Governments need to use the current crisis this opportunity to allow the labor and capital markets to correct them, improving the efficiency of local resources. While any job losses at this time will obviously be unsavoury, the efficiency and competitiveness advantages that will come from proper reform will help to create jobs in the long term. It is up to policymakers to ensure that this message is communicated to the public.

Secondly, developed EU nations such as Germany must take the lead in assisting weaker economies to weather the financial storm and to properly meet EU guidelines for adoption of the Euro and accession to the Euro zone. The developed EU economies also stand to gain from assisting economies such as Eastern Europe by ensuring that the market for exports that has benefited from the adoption of the single market continues to thrive. Essentially, countries such as Germany will be securing markets for their own exports, which in turn bolster their own manufacturing industries. In addition to this, economic cooperation with emerging economies allows countries such as Germany to speed up the process of expanding the Euro zone and the adoption of the Euro. The biggest hurdle to this expansion has been the reluctance of the Baltic States to adopt economic reforms and guidelines. This can be used as a carrot to encourage a higher level of regulation and corporate responsibility, strengthening the economic state of the EU as a whole.

Finally, emerging economies in the EU must make themselves available for help and be willing to accept the conditions of that help. Apart from the initial cash injections, cooperation with the rest of Europe will bring about three major benefits to emerging economies. Firstly, by accepting regulation and reform, emerging countries will become less susceptible to the volatile capital markets through the rebuilding of solid economic foundations with the developed economies of Europe. Secondly, for those countries that have not yet joined the Euro, economic cooperation will speed up the required compliance process. By cooperating with the economic leaders of the EU, emerging economies will be able to show they are ready and stable enough to join the Euro. Finally, by showing themselves to be reasonable and responsible financial managers, emerging economies will gain credibility on the global stage.

³⁸ The Economist. (2009, April 23). *Not like the neighbours - Poland's economic strength*. <http://www.economist.com/displaystory.cfm?story_id=13527532> accessed 26 April 2009

Any response to the financial crisis must be coordinated and decisive. Regardless of state borders, the European Union now operates as a single unit. Its fiscal and monetary policy should therefore be formulated as a whole. The European Commission must formulate a true coordinated response, with specific guidelines regarding the allocation of funds. The fundamentals of the European economy seem strong. As in any public policymaking, the role of policy makers is to provide the market with the tools to exploit the strengths of its marketplace. Unfortunately, it seems most of the action has been left to Member States and will of political agendas which as can be expected in a crisis of this nature are protectionist in nature. Commissioner Almunia avers to this in his speech at the John Hopkins University.³⁹ He states that the EU must not go down the path of protectionism but must ensure an open and fair multilateral trading system and free flows cross border investment. Europe must boost increased investment in research and innovation and create more flexible markets in order to promote business. Finally he states the transition to a low carbon economy must continue with a focus on carbon reduction and renewable energy accompanied by cleaner technologies.⁴⁰

³⁹ Joaquin Almunia European Commissioner for Economic and Monetary Policy 'Confronting the global Financial Crisis: The European Response John Hopkins School of Advanced International Studies Washington 24 April 2009 Speech 09/195 <europa.eu/rapid/pressReleasesAction.do?reference=SPEECH/09/195&format=../> accessed 9 May 2009

⁴⁰ *ibid*